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Emerging Markets in the Age of Mechanical Reproduction

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I. INTRODUCTION

Markets often spring up unannounced and in the most peculiar of places. Economists have "found" markets everywhere — from the bedroom to the boardroom, and every other meeting place in between. Sometimes these unruly markets are unwelcome, as for example the market for human kidneys in certain towns in India.[1] It has now become

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[1] Clarence Fernandez, *New Indian Law Spurs Crackdown on Kidney Racket*, Reuters, Mar. 23, 1995, *available in* LEXIS, News Library, Curnws File. *See also*

good form (at least among lawyers and economists) to provide some justification for not wanting a market in a particular location, or with respect to a particular commodity.[2] Justifications range from moral concerns to a concern with Pareto optimality. Controversial commodities include DNA strips,[3] babies,[4] body organs of the newly-deceased,[5] or the cash-strapped but still living "donor," the bodies of men or women "rented" for sex, and, in some parts of the world, children and adults sold into perpetual servitude.

If markets pop up in even the most unwanted places, it would seem logical to conclude that we can produce them at will with little trouble. However, recent experience in Eastern Europe shows that you can take markets to water, but you cannot always make them drink. In other words, there is a very fine line between creating viable markets and inducing market failure, between creating the institutions of capitalism and helping foster political institutions that act as a bulwark against greater economic liberalization.[6] After six years of "transition," it has become obvious that creating markets in transition economies, such as those in Eastern Europe, is not as easy as the first capitalist missionaries thought when they packed their bags from various venues in Cambridge and found their way to Prague and beyond. It has become clear that

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India to set up Human Organ Bank, Aug. 24, 1995, *available in* LEXIS, News Library, Curnws File.

[2] *See, e.g.*, Margaret J. Radin, *Market-Inalienability*, 100 HARV. L. REV. 1849 (1987).

[3] *Cf.* Moore v. Regents of the University of California, 793 P.2d 479 (Cal. 1990) (patented cell line).

[4] *See* Elizabeth M. Landes & Richard A. Posner, *The Economics of the Baby Shortage*, 7 J. LEG. STUD. 323 (1978); Richard A. Posner, *Adoption & Market Theory: The Regulation of the Market in Adoption*, 67 B.U. L. REV. 59 (1987). For an earlier treatment, see Jonathan Swift, *A Modest Proposal for Preventing the Children of Poor People from Being a Burden to Their Parents or the Country & Making Them Beneficial to the Public*, *in* JONATHAN SWIFT 492 (A. Ross & D. Wooley eds., 1984).

[5] *See, e.g.*, Lloyd R. Cohen, *Increasing the Supply of Transplant Organs: The Virtues of a Futures Market*, 58 GEO. WASH. L. REV. 1 (1989); *China Must Halt Human Organ Trade*, THE HERALD (Glaslow), Mar. 21, 1995, *available in* LEXIS, News Library, Curnws File; Anna Pukas, *The Global Lie that Cannot be Silenced*, SUNDAY TIMES, July 16, 1995, *available in* LEXIS, News Library, Curnws File.

[6] On the interrelation of the political and the economic in the transition process, see ALICE H. AMSDEN ET AL., THE MARKET MEETS ITS MATCH: RESTRUCTURING THE ECONOMIES OF EASTERN EUROPE 158-205 (1993); RALF DAHRENDORF, REFLECTIONS ON THE REVOLUTION IN EUROPE (1990); ADAM PRZEWORSKI, DEMOCRACY AND THE MARKET: POLITICAL AND ECONOMIC REFORMS IN EASTERN EUROPE AND LATIN AMERICA (1991); STEPHEN WHITE ET AL., THE POLITICS OF TRANSITION: SHAPING A POST-SOVIET FUTURE (1993); Alfred Schipke, *The Political Economy of Privatization*, *in* THE ECONOMICS OF TRANSFORMATION: THEORY AND PRACTICE IN THE NEW MARKET ECONOMIES 171 (Alfred Schipke & Alan M. Taylor eds., 1994).

there are a number of economic, legal, and institutional constraints to creating viable markets.[7] A first step to a successful transition requires identifying these constraints and finding ways of dealing with them — not in a short term, ad hoc manner, but in a well thought-out and systematic fashion.

In this essay, I use a bargaining paradigm to identify some of the major roadblocks to the shift from planned to market economies. In particular, I focus on two types of well-known problems that make economic interactions difficult to manage: (1) collective action problems, and (2) agency problems. Part of the reason that the "big bangs" have, in many cases, turned into "big busts"[8] is due to the "new capitalist planners' " failure to take into account certain collective action and agency problems involved in the creation of new markets. This essay seeks to identify these problems and to point toward some possible solutions.

II. What is to be Un-Done

A natural place to start is by identifying some of the principal tasks that need to be accomplished. The process of economic and political transition in Eastern Europe is usually described as one of disaggregation and decentralization — a move from centrally planned and run economies,[9]

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[7] The literature on market failure and that on institutional change should have alerted potential reformers of the difficulties involved. Although the market failure literature has principally focused on failures of particular markets within established market economies, it can be easily extended to the broader issue of creating market economies generally. This is particularly the case when one factors in the current learning on the difficulties of effecting institutional change in even the best run of market economies. On market failure see Kenneth J. Arrow, The Limits of Organization (1974); Public Goods & Market Failures: A Critical Examination (Tyler Cowen ed. 1992); John O. Ledyard, *Market Failure*, *in* The New Palgrave: Allocation, Information and Markets 185 (John Eatwell et al. eds., 1989). On institutional change, see Douglass C. North, Institutions, Institutional Change and Economic Performance (1990); Douglass C. North, Structure and Change in Economic History (1981); Mark Granovetter, *Economic Action and Social Structure: The Problem of Embeddedness*, *in* The Sociology of Economic Life 53 (Mark Granovetter & Richard Swedberg eds., 1992); Margaret Levi, *A Logic of Institutional Change*, *in* The Limits of Rationality 402 (Karen Schweers Cook & Margaret Levi eds., 1990). On institutional inertia in the former Soviet Union, see Holger C. Wolf, *The Economics of Disintegration in the Former Soviet Union*, *in* The Economics of Transformation: Theory and Practice in the New Market Economies 1 (Alfred Schipke & Alan M. Taylor eds., 1994).

[8] *See* Alice H. Amsden et al., The Market Meets its Match: Restructuring the Economies of Eastern Europe 1-4 (1994).

[9] On the virtues and limitations of planning see generally, Oskar Lange & Fred M. Taylor, On the Economic Theory of Socialism (1938); Friedrich A. Hayek, *The Nature and History of the Problem*, *in* Individualism and Economic

to those in which private actors have property rights in the factors and outputs of production. It is as if somehow the whole populace were being invited for one more trip behind the Rawlsian veil.[10] In reality, however, policymakers are not faced with a *tabula rasa*. Instead, they are dealing with path-dependent institutions, laden with history, and not easily malleable.[11] Furthermore, it is not possible to completely undo the past and start from scratch. Neurath's oft-quoted analogy is apt at this point: "[W]e are in the position of a mariner who must rebuild his ship plank by plank while continuing to stay afloat on the open sea."[12]

A. *The Mother Firm: From One All-Encompassing Holding Company to a Market Economy*

Coase was the first economist to study seriously why some production is carried out through firms while other production is carried out across markets.[13] The obvious (but not completely enlightening) answer is that production is carried out through firms when it is cheaper than to carry it out through markets. After Coase's "The Problem of Social Cost" in 1960,[14] and the work of transaction cost-minded economists such as Cheung[15] and Williamson,[16] a large literature developed dealing with the issue of the boundary between firms and markets. A corollary question has emerged from this literature: why is not all production carried out in one big firm? As early as 1937, Coase provided some preliminary reasons.[17] We do not need to delve deeply into this theoretical quagmire, but it is useful to borrow from it to better understand the issues faced by Eastern European transition economies.

ORDER 119 (1948); FRIEDRICH A. HAYEK, *The State of the Debate*, *in* INDIVIDUALISM AND ECONOMIC ORDER 148 (1948); Alec Nove, *Planned Economy*, *in* THE NEW PALGRAVE: PROBLEMS OF THE PLANNED ECONOMY 186 (John Eatwell et al. eds., 1990).

[10] For the original position on these issues, see JOHN RAWLS, A THEORY OF JUSTICE (1971).

[11] On path dependent institutions, see W. BRIAN ARTHUR, INCREASING RETURNS AND PATH DEPENDENCE IN THE ECONOMY (1994); RICHARD H. DAY, COMPLEX ECONOMIC DYNAMICS (1994); DOUGLASS C. NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE (1990).

[12] *Quoted in* W. V. QUINE, *On Mental Entities*, *in* THE WAYS OF PARADOX AND OTHER ESSAYS 208, 210 (1966).

[13] Ronald Coase, *The Nature of The Firm*, 4 ECONOMICA 386 (1937), *reprinted in* RONALD COASE, THE FIRM, THE MARKET, AND THE LAW 33 (1988) [hereinafter *The Nature of the Firm*].

[14] Ronald Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1 (1960), *reprinted in* RONALD COASE, THE FIRM, THE MARKET, AND THE LAW 95 (1988).

[15] *See* Steven Cheung, *The Contractual Nature of the Firm*, 26 J.L. & ECON. 1 (1983).

[16] *See* OLIVER WILLIAMSON, THE ECONOMIC INSTITUTIONS OF CAPITALISM (1985).

[17] *See The Nature of the Firm*, *supra* note 14, at 51-53.

To avoid the constraints of history, we might imagine a fictitious Eastern European country ("Atlantis") moving from a planned to a capitalist economy. Assume that Atlantis had been under a Soviet-style political and economic regime. We can assume that production was completely centralized, and thus we can view it as being carried out through one firm — call it the "Mother Firm." The same problems faced by an IBM or an Exxon in trying to determine how much production to carry out internally and how much through the market is ostensibly faced by the CEO of the Mother Firm in Atlantis. The problem, however, is that political contingencies and constraints make it harder (and in some cases impossible) to shift production outside of the Mother Firm.

Now assume that Atlantis chucks its political and economic chains (and decides to dis-unite). One question that immediately arises is: what types of production should be moved outside of the Mother Firm? We can expect that decentralization within Atlantis will in some ways resemble decentralization within large conglomerates that have decided to downsize their operations by spinning off some of their subsidiaries. In other words, one can view the Mother Firm as an all-encompassing holding company. The Mother Firm had been able to keep this conglomerate together by political and economic fiat. What is important to realize is that behind the political structure lay an economic one, that, when stripped away from the political, appears quite familiar to those with a capitalist (or at least a transaction-cost) gaze. In other words, it is just one big inefficient firm held together by motivations other than those of minimizing production and transaction costs.

Once the political glue gives way and transaction costs rear their realigning heads, the Mother Firm is exposed as being too big — too vertically and horizontally integrated for its own good. Although the Mother Firm had been so all encompassing, inevitably internal markets had developed. However, the usual full-fledged external markets that one would expect in a home-grown capitalist economy are found to have been underdeveloped.[18]

As a multitude of firms is spun off from the Mother Firm, it quickly becomes clear that there is an institutional gap of sorts. The usual institutions associated with market capitalism are nowhere to be found, or are highly underdeveloped. The question then becomes: how do we create such institutions? Can we simply purchase "turn-key" institutions from capitalist missionaries? Can we squeeze history into a ball and expect institutions to emerge that "mimic" the institutions that have fully undertaken a full-fledged minuet with evolution?

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[18] For a general discussion of market problems in countries where central planning is the main mechanism of resource allocation, see PAUL MARER, *Roadblocks to Changing Economic Systems in Eastern Europe*, *in* FROM SOCIALISM TO MARKET ECONOMY: THE TRANSITION PROBLEM 9, 20-23 (William S. Kern ed., 1992).

These questions become more tractable if we view the move from one all-encompassing firm to a collection of firms through the same lens with which we analyze the feasibility of vertical and horizontal integration within existing capitalist economies. One thing that becomes clear is that not all firms within the Mother Company should be branded as useless scrap or in need of total transformation into Western style companies. In certain cases, one will have to redefine the boundary between these spun-off firms and the markets in which they operate. For example, we may want to divide these firms into smaller ones or discontinue internal production in some sectors, relying instead on production across markets. But a large portion of human capital and organizational know-how and skill would be lost if one were to simply brand these firms as inefficient and useless offspring of the Mother Firm.

B. *A Bargaining Perspective*

One way to look at the transition in Eastern Europe is through the lens of bargaining theory.[19] In other words, the interested parties are in the midst of redividing the social pie. As in any case where parties are interested in dividing certain surpluses among themselves, we have to take into account the distributive consequences (i.e., how the pie is to be cut and distributed).

Assume, for example, that the leaders of one of these transition countries can tell the populace (and themselves — since they are taking a slice themselves) that moving toward a capitalist economy will lead to the production of a larger social pie. If I am an individual deciding on whether to cooperate in producing this larger pie or to oppose it, I am concerned not only with how much bigger the pie becomes (the production aspect), but also with whether I am to receive a greater amount of this social surplus than I was receiving under the old system or under an alternate system (the distribution aspect).[20] As a result of this, policy-makers can not just offer a larger pie, but they must also show that the inevitable redistribution in the move towards capitalism will make the concerned

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[19] For a discussion of a bargaining game between shareholders and labor, see MASAHIKO AOKI, THE CO-OPERATIVE GAME THEORY OF THE FIRM (1984); for a discussion of bargaining between shareholders and creditors, see Douglas G. Baird & Randal C. Picker, *A Simple Noncooperative Bargaining Model of Corporate Reorganization*, 20 J. LEGAL STUD. 311 (1991); for a discussion of bargaining between shareholders and managers, see Manuel A. Utset, *Towards a Bargaining Theory of the Firm*, 80 CORNELL L. REV. 540 (1995).

[20] This is Robert Cooter's point that production of the good depends on reaching agreement over the distributional issue. *See* Robert Cooter, *The Cost of Coase*, 11 J. LEGAL STUD. 1, 17 (1982).

parties better off than they were under the old system (or under an alternate system).[21]

1. The Merchants of Change: Who's Who in Emerging Markets

In order to understand the bargaining interaction involved, we must: (1) identify the principal parties involved in the transition in Eastern Europe; (2) pinpoint their particular interests; and (3) determine where and when these interests are likely to come into conflict. This will allow us to get a better idea of who is likely to favor certain reforms and who is likely to oppose them.

We can divide the set of actors involved into two broad (and obvious) categories: domestic actors; and foreign actors.[22] The domestic actors can be divided into four groups: (1) government officials; (2) their constituencies; (3) managers; and (4) labor.[23] The foreign actors are divided as follows: (1) sovereigns (i.e., governments with an interest in the region); (2) intermediaries, both financial and non-financial; and (3) direct investors (i.e., companies and other entrepreneurs making direct capital investments in the region).

a. *Domestic Government Officials*

Domestic government officials have a large degree of formal power, but limited financial clout. This is a handicap when dealing with potential foreign investors. The shift from relative isolation and a world where power was a function of military strength, to an increased dependence on Western capital in a world where power is measured in dollars, has left government officials with more limited bargaining power than they would like.

In addition, the ability of the government to act as a unified bargaining actor has been undermined by the decentralization of the government infrastructure.[24] As different agencies and officials begin to acquire

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[21] I am assuming that the populace has adequate information regarding the redistributive effects involved and that they have some ability to discipline government actors. Of course, these assumptions will not hold in every relevant situation, but they allow us to identify some of the constraints faced by potential reformers.

For a discussion of why the Pareto-optimal institutions may not emerge as one moves towards democracy see ADAM PRZEWORSKI, DEMOCRACY AND THE MARKET: POLITICAL AND ECONOMIC REFORMS IN EASTERN EUROPE AND LATIN AMERICA 136-139 (1991).

[22] This is merely one way of drawing the line among different actors; it is quite artificial, but it will do for our purposes, since the goal here is to set forth the different types of actors involved and not to bind them to specific pigeonholes.

[23] While there are some overlaps in these categories, it does not affect the analysis.

[24] *See United Nations Workshop to Review Programmes of Decentralization in Countries of Eastern Europe to be Held in Netherlands*, FNS, Nov. 29, 1993, *available in* LEXIS, News Library, Arcnws File.

independent spheres of influence and specialized constituencies, they undermine the bargaining power of the government as a whole *vis-á-vis* foreign investors.[25] For one thing, foreign investors are able to "official-shop" until they find a government official or agency, with certain autonomous power, that can help them in their endeavors. This help might come from direct approval of an investment or a project, or from having these friendly officials act as their "agents" *vis-á-vis* other government officials.[26]

As we have seen it is not always easy to cut off the past and start in a totally new direction with a clean slate. In the "new" Eastern Europe, this is reflected in the fact that government officials comprise both refurbished communists[27] as well as officials who were not part of the old governments, and who in certain cases, had been in either open or disguised opposition to the previous regimes.

One outcome of creating new markets, privatizing companies, and encouraging foreign investments is that bureaucrats have less to do. The boundary between the government and the market is shifted so that the "production" tasks that had previously been undertaken by the government are transferred to the market. Market transactors may be individuals within private "firms" or independent contractors transacting across markets. The successful transactors will be those with a relative economic advantage as opposed to a political one. This bureaucratic "idleness" has led to an increase in the amount of red tape wrapped around

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[25] If the government officials can somehow coordinate their actions, the existence of such divisions in power may be used as a bargaining advantage. For example, in the United States the constitutional requirement that the Senate ratify foreign treaties may give the President certain bargaining advantages, if she can convince the other country that the Senate will only accept certain specified terms. In other words, the President may be able to send a credible signal that the U.S. government is precommitted to certain terms, and that it is beyond her power to bargain around those terms. For the classic discussion on precommitment as a bargaining strategy, see THOMAS C. SCHELLING, THE STRATEGY OF CONFLICT (1960).

[26] Of course, this type of interaction is nothing new in the world of cross-border transactions. For example, The Foreign Corrupt Practices Act was meant to prevent overzealous U.S. companies from "overpaying" their "government agents" in other countries. Foreign Corrupt Practices Act Amendments of 1988, Pub. L. No. 100-418, §§ 5001-5003, 102 Stat. 1415 (1988) (current version at 15 U.S.C. § 78dd-1 (1994)). What is new in Eastern Europe is the decentralization of decision-making, which can have the effect of increasing "official shopping" and related endeavors. On the sins of rentseeking, see, e.g., Gordon Tullock, *The Cost of Special Privilege*, *in* PERSPECTIVES ON POSITIVE POLITICAL ECONOMY 195 (James E. Alt & Kenneth A. Shepsle eds., 1990).

[27] The election of Communist leaders has been referred to as the "Red Return." Samuel Huntington, *Democracy for the Long Haul*, STRAITS TIMES (SINGAPORE), Sept. 10, 1995, *available in* LEXIS, News Library, Curnws File (stating that "apart from the Czech Republic, most of the leaders . . . [in Central and Eastern Europe] are former communists").

potential business transactions by foreign investors.[28] Red tape may take time, but it helps save the jobs of former planners now turned full time "regulators."

b. *Domestic Constituencies*

When foreign investors look at Eastern Europe, they see "markets"— i.e., they see an untapped source of potential consumers. While this makes perfect sense, it is important to keep in mind the other hats worn by individuals in these emerging markets. In other words, the success of actually creating viable markets will be affected by the different interests of the individuals involved and the different contexts in which they interact.

Just as there has been a fragmentation in the government infrastructure, there has also been a fragmentation among the population.[29] This is a function of the increasing types of activities and interactions — political, economic, religious, and ethnic — that individuals within these societies are allowed to undertake.[30] It is not surprising that as the cost of undertaking these different types of activities has decreased — i.e., as government prohibitions and penalties were reduced or disappeared — the number of these actions increased. Of course, there is nothing wrong with this development (in some sectors it is called "freedom" or "liberty"); our concern here is to determine how it would affect the creation of viable markets and the attraction of foreign investments.

If history (or economics) is any guide, one would assume that individuals who suffer economically in the transition — labor, old bureaucrats, the unemployed, price-sensitive consumers — will resort to political participation to redress these economic "injustices."[31] As a result these potential responses by affected individuals have to be factored into the

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28 *See, e.g., Foreign Investment in Bulgaria Hits $780 Million*, Reuters, Jan. 16, 1995, *available in* LEXIS, News Library, Arcnws File (reporting that red tape has hampered foreign investment in Bulgaria).

29 One would expect that such fragmentation would occur as one moves towards a more democratic pluralistic society. *See* PRZEWORSKI *supra* note 21, at 10-14. For a subtle and detailed discussion of how democratic institutions cope with the incompatible doctrines invariably held by different portions of the populace in pluralistic societies, see JOHN RAWLS, POLITICAL LIBERALISM (1993).

30 *See, e.g.*, Cathy Waugh, *Estonian Premier Predicts Change in Power*, UPI, Mar. 3, 1995, *available in* LEXIS, News Library, Arcnws File (identifying some sixteen political parties contesting the Estonian election; including the Reform Party, the Rural Union Party, the Fatherland and the Estonian National Independence Party, and environmental groups, royalists, right-wingers, the Russian minority, and two Estonian-Americans).

31 *See* John Pomfret, *Reform Wins: Dissidents Lose*, WASH. POST, Oct. 24, 1994, at A1.

calculus.[32] One of the arguments for a "big bang" transition was that it would make Thermidorean reactions less likely. The see-saw battles between fast-track and slow-track reformers in Eastern Europe have shown us that there are always Robespierres lurking about. In fact, if one wants to know which way the wind is blowing at any particular time, one merely has to figure out which set of economists are unemployed. The important point, however, is that there are going to be political shifts, and in order to better ascertain the probability distributions associated with those shifts, one needs to factor in all the variables.

c. *Managers of Domestic Firms*

It is hard to ascertain the "carry-over" value of managers of old planned-economy firms. For one thing, there is a tendency to blame them unduly for the failures of their companies during the socialist era. The problem faced by decision makers is a typical agency problem: it is difficult to ascertain the extent to which the negative results were caused by bad "management" — whatever that may mean in a planned economy — as opposed to bad central planning.

With the shift from planned to capitalist economies, some of the skills required of managers will undoubtedly change. Certain skills that are required to be a successful "capitalist" manager were not required of managers in planned economies, and thus were underdeveloped. This is because it does not make sense for managers to expend their human capital to acquire skills that would produce negative net returns to themselves. One would expect that the underdeveloped skills included those usually associated with the following areas: (1) marketing; (2) product differentiation; (3) consumer relations; (4) quality control; (5) long-term strategic planning; (6) raising capital; (7) dealing with competitors — including the identification competitors and potential entrants, and the acquisition and maintenance of market share; and (8) dealing with international competitors and foreign markets.

d. *Labor in Domestic Firms*

Reformers in Eastern Europe can learn a little from the leveraged-buyout (LBO) boom in the U.S. in the 1980's.[33] Individuals involved in

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[32] An analogous situation occurred in the United States during the late 1980's when after it seemed as if those in favor of less managerial intervention in takeover decisions had won the day in the courts and academic journals, managers of public corporations convinced legislatures (in the name of employees within those states) to adopt anti-takeover statutes. *See, e.g.*, P.R. Chandy et al., *The Shareholder Wealth Effects of the Pennsylvania Fourth Generation Anti-Takeover Law*, 32 AM. BUS. L.J. 399, 411 (1995) (discussing anti-takeover statutes in Pennsylvania).

[33] For discussions on leveraged-buyouts, see Michael C. Jensen, *Active Investors, LBO's, and the Privatization of Bankruptcy*, 27 CONTINENTAL BANK J. OF APPLIED CORP. FIN. 35 (1989).

structuring LBO's many times exaggerated the amount of extra productivity that could be squeezed out of employees.[34] It is undoubtedly true that reducing the workforce (and being under a constant threat of being part of the reduction plan) can increase productivity and cut production costs. As in the LBO context, the parties involved in restructuring Eastern European companies have tended to overestimate how much they could squeeze out of workers. The experience in some Eastern European companies has been that the workers' reservation price turned out to be much higher than was anticipated.[35] Thus, many workers simply quit when faced with lower wages, and in some cases, companies were left with a shortage of skilled workers.[36]

e. *Foreign Sovereigns and Other Foreign Intermediaries*

The United States, Germany, and other Western European countries have an obvious political interest in the stability of the new governments in Eastern Europe. They also have an interest in exploiting these new markets. These interests need to be factored in when one is assessing the role of "foreign assistance" in these transition economies.

The World Bank and other financial and developmental intermediaries also play a large role in the move towards capitalism.[37] Unfortunately, these institutions have a long history of dealing with developing countries whose economies are very different from those in Eastern Europe.[38] The strong-arm tactics and fiscally stringent conditions that usually accompany these institutions' willingness to provide "aid" are ill-suited to the still highly-charged political scene in Eastern Europe.[39] The old debates about the interrelation between political development and economic

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[34] *See* Jackie Ruff, *Job Security in Poland: Economic Privatization Policy and Workplace Protections*, 7 TEMP. INT'L & COMP. L.J. 1, 3 (1993).

[35] *See, e.g.*, Sanford J. Grossman & Oliver D. Hart, *An Analysis of the Principal-Agent Problem*, 51 ECONOMETRICA, 7, 11 (1983) (defining reservation price as the expected level of utility that a potential agent can achieve by working somewhere else).

[36] ALICE H. AMSDEN ET AL., THE MARKET MEETS ITS MATCH: RESTRUCTURING THE ECONOMIES OF EASTERN EUROPE 79-81 (1993).

[37] For a discussion of the World Bank's role in transition economies, see Kim Reisman, Note, *The World Bank and the IMF: At the Forefront of World Transformation*, 60 FORDHAM L. REV. 349 (1992); Mary M. Shirley, *The What, Why and How of Privatization: A World Bank Perspective*, 60 FORDHAM L. REV. 23 (1992).

[38] *See* Alan S. Greenspan, Forum, *Thoughts About the Transitioning Market Economies of Eastern Europe and the Former Soviet Union*, 6 DEPAUL BUS. L.J. 1, 3 nn.3-4 (1993).

[39] ALICE H. AMSDEN ET AL., THE MARKET MEETS ITS MATCH: RESTRUCTURING THE ECONOMIES OF EASTERN EUROPE 113-128 (1993); Reisman, *supra* note 37, at 388 n.338.

development are quite apropos, and dusting off some texts from the 1960's and 70's might not be a bad idea.

f. *Foreign Direct Investors*

An important issue that needs to be addressed is how the transition economies can convince investors to invest in these "new" firms.[40] This is familiar to anybody involved in the practice of creating and selling firms. We want investors not only to part with their money, but also to minimize the amount by which they discount the value of the new companies.[41] The greater the risks involved with the investment, the greater the discount. This is complicated by the fact that investors come in different shades — of particular importance here is the distinction between foreign investors and domestic investors.[42] Given the current historical contingencies, it is the foreign investors that — by and large — have the greenbacks, or the marks, or the what not.[43]

Of further concern are the political risks involved.[44] One question that any investor would want to have answered is: how can we get the government to precommit to certain non-interventionist parameters?[45] A second question is: what are my exit strategies?[46]

2. Collective Action: Who is to Provide Public Goods When the Government is a Suspect Class?

While all (or at least the majority of) the parties mentioned above are involved in a common enterprise, particularly if we define "enterprise"

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40 For a discussion of foreign investments in the "new" Eastern Europe, see Paul J.J. Welfens, *Foreign Direct Investment and Privatization*, *in* THE ECONOMICS OF TRANSFORMATION: THEORY AND PRACTICE IN THE NEW MARKET ECONOMIES 129 (Alfred Schipke & Alan M. Taylor eds., 1994).

41 For a general discussion of the tradeoffs between discounting for risks by reducing the price one is willing to pay for a transaction and adopting governance structures to deal with these risks see WILLIAMSON, *supra* note 16.

42 *See* William C. Philbrick, *The Task of Regulating Investment Funds in the Formerly Centrally Planned Economies*, 8 EMORY INT'L L. REV. 539, 557 (1994); Note, *Investing in Democracy: Joint Venture Opportunities in the Czech and Slovak Federal Republic*, 18 SYRACUSE J. INT'L L. & COM. 199, 201-02 (1992).

43 *See* Philbrick, *supra* note 42, at 573.

44 *See id.* at 544-45; Gloria L. Sandrino, *The NAFTA Investment Chapter and Foreign Direct Investment in Mexico: A Third World Perspective*, 27 VAND. J. TRANSNAT'L L. 259, 265 (1994).

45 On the issue of credible commitments by governments not to appropriate wealth in the future, see Barry B. Weingast, *The Economic Role of Political Institutions: Market Preserving Federalism and Economic Development*, 11 J. L. ECON. & ORG. 1 (1995).

46 On "exit" strategies see ALBERT O. HIRSCHMAN, EXIT, VOICE AND LOYALTY: RESPONSES TO DECLINES IN FIRMS, ORGANIZATIONS, AND STATES (1970).

broadly enough, they each have their own private interests.[47] Endeavors to realize these private interests may, in certain circumstances, undermine the whole enterprise. In other words, collective action problems may undo the whole enterprise.

For example, we can begin by assuming (for purposes of this argument) that all of the parties above have the same principal goal — namely, of helping create certain institutions of capitalism and restructuring inefficient firms. Carrying out these transformations will take time and money. Investments must be made in (1) firms; (2) intermediary independent institutions — stock markets and other third-party intermediaries; and (3) the government process — public choice requires private expenditures. Given the move towards decentralization, we can make the assumption (which will not be true for all cases) that no one party undertaking these actions will be able to get a return from so doing that is greater than his own investment. But most importantly, these are public goods that are being produced, and parties who do not undertake any expenditures in helping bring them about can still partake of the benefits produced. This results in a classic collective action problem.

The usual solution to this type of collective action problem is to have the public good produced by government entities. However, at least at first glance, this solution proves problematic in Eastern Europe — a solution that requires greater government intervention is anathema to those who are struggling to distance the economic from the political. In the end, however, it may very well prove that even though Marx is dead, disentangling the economic from the political will not be as easy as moving all the books on Marxism from the political science section to the history section of local libraries.

3. A Nexus of Contracts

The intertwined parties described above can be understood as being involved in myriad agency relationships among themselves. In examining these relationships, it is useful to borrow Jensen and Meckling's concept of a "nexus of contracts."[48]

As mentioned above, during the transition period these parties are involved in a common enterprise of sorts. The above discussion of collective action problems allowed us to see some group dynamic problems of achieving cooperation. Focusing on agency theory allows us to highlight a different problem: namely, one arising from the fact that the parties have conflicting interests and will act strategically when interacting with each

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47 *See generally* RUSSELL HARDIN, COLLECTIVE ACTION (1982); MANCUR OLSON, THE LOGIC OF COLLECTIVE ACTION (1971); TODD SANDLER, COLLECTIVE ACTION: THEORY AND APPLICATIONS (1992).

48 *See* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

other. Thus, cooperation may fail for reasons other than the free-rider problem analyzed above.

Agency relations will arise in this context because some of these parties will have to (or will find it profitable to) depend on the actions of other parties. Furthermore, not all parties will have access to the same information or the same means of verifying common information. In these situations of informational asymmetry, a party acting on behalf of another, or acting in a way that affects the other's welfare, may engage in certain acts that are different from those that the dependent party would want taken if the dependent party had complete information. This, of course, leads to well-known agency problems.

The nexus-of-contract paradigm allows us to focus on the fact that notwithstanding the agency problems involved, the parties are still involved in some sort of common enterprise during the transition period. We can assume that the parties involved will subject themselves to various explicit and implicit contracts to constrain and coordinate their behavior. Thus, the nexus-of-contract paradigm allows us to get a better understanding of (1) how the relationships among different parties emerge; (2) how they are governed; and (3) how they change with the passing of time (this may include the emergence of new parties or the changing of the environment in which the parties interact).

A fuller exposition of the issues raised in this essay would require us to examine how (and to what extent) new "capitalist firms" should be created: (1) what are the preconditions for the emergence of these firms?; (2) how do we draw boundaries between the market and these firms?; and (3) what is the setting in which these firms will operate? This last question would require us to analyze: (1) how certain "disciplining markets" arise (or are created), keeping in mind that these disciplining markets, in many cases, transcend national and regional borders; and (2) how to set up mechanisms to prevent governments in these transition countries from over-indulging in the benefits of the new economic system, while, at the same time, intervening "strategically" where needed. These inquiries are left for later projects.

III. Conclusion

While the rallying cry within transition economies has been one of taking the "pop" out of government (particularly when the ralliers are foreign advisors), one cannot create viable markets merely by tying the hands of government officials. Laissez-faire economics is too haphazard a way of running emerging domestic economies which are embedded in a wider international economy where everything is fair game. The transition in Eastern Europe requires government intervention in the economy, if new firms are to emerge and survive. Market failures arising out of collective action and agency problems will in many instances require some government intervention, even if in the end the parties are able to achieve some sort of private ordering.

If we view the situation through a bargaining lens as we did above, then there is some room for government intervention in helping coordinate interactions between the various interested parties. By the same token, however, these governments have to be able to precommit to the continuation of certain policies of limited and strategic intervention if they want to attract foreign investors and not have them greatly discount the value of assets being purchased and of investments being made.

The move from the Mother Firm to an economy of free-standing firms competing in well-developed markets cannot be accomplished by fiat. There is more to the creation of markets than the edict of a Chicago-trained sovereign proclaiming: "Let there be markets." Political institutions are not easily bought or mimicked, and Thermidorean reactions remain a constant threat. As a result, combining political and economic change, as has been done in Eastern Europe, creates a feedback effect between these two sectors. Thus policy-makers — at least those not well endowed with Golden Parachutes — should be on guard.

In the end, it seems that invisible hands cannot work their magic unless the affected populace has by and large given up on the ethic of governmental paternalism. As the grain riots in Ancient Rome made quite clear, a hungry crowd is always ready to turn around and bite hard on the hand that it believes should be feeding it.